

STATE OF NEW YORK

DIVISION OF TAX APPEALS

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In the Matter of the Petition	:	
of	:	
<b>93RD STREET ASSOCIATES</b>	:	<b>DETERMINATION</b>
for Revision of a Determination or for Refund	:	<b>DTA NO. 814086</b>
of Tax on Gains Derived from Certain Real	:	
Property Transfers under Article 31-B of the	:	
Tax Law.	:	

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Petitioner, 93rd Street Associates, c/o Tishman Realty Construction, 666 Fifth Avenue, New York, New York 10103, filed a petition for revision of a determination or for refund of tax on gains derived from certain real property transfers under Article 31-B of the Tax Law.

On February 26, 1996 and March 4, 1996, respectively, petitioner, by its representative, Hutton and Solomon, LLP (Roy F. Hutton, Esq., of counsel), and the Division of Taxation by Steven U. Teitelbaum, Esq. (Herbert M. Friedman, Esq., of counsel), waived a hearing and agreed to submit this case for determination based on documents and briefs to be submitted by July 5, 1996. Documentary evidence, agreed to by the parties' representatives, was submitted for the record on April 12, 1996. On April 15, 1996 a stipulation of facts, executed by the parties' representatives on April 11, 1996, was submitted for the record. Petitioner's brief was submitted on May 15, 1996. The Division of Taxation's brief was submitted thereafter on June 14, 1996. Petitioner's reply brief was submitted on June 28, 1996, which date commenced the six-month period for the issuance of this determination (Tax Law § 2010[3]). After review of the evidence and arguments presented, Dennis M. Galliher, Administrative Law Judge, renders the following determination.

***ISSUES***

I. Whether petitioner may reduce the consideration received for its transfer of real property based upon its payment in settlement of ongoing litigation over construction defects in

the property, where such settlement was reached and payment was made to the property transferees subsequent to the transfer of the real property.

II. Whether legal fees incurred by petitioner in defending against the above-noted litigation over construction defects constituted ordinary, necessary and reasonable selling expenses properly includable in original purchase price for the property.

### ***FINDINGS OF FACT***

1. The facts in this case are not in dispute and have been stipulated. Petitioner, 93rd Street Associates, was the sponsor of Astor Terrace Condominium, a residential condominium development located at 245 East 93rd Street in New York, New York ("the Project").

2. All of the units in the Project were sold between February 1985 and January 1990. Petitioner paid the gains tax on each unit sold as required by the Division of Taxation ("the Division").<sup>1</sup>

3. In July 1988, the Board of Managers of Astor Terrace ("the Board") brought an action against petitioner ("the Lawsuit") on behalf of the owners of the units purchased from petitioner seeking damages for breach of the contracts for the sales of the units.

4. In July 1993, the Board and petitioner settled the Lawsuit. The terms of the settlement included a payment of \$1,500,000.00 from petitioner to the Board.

5. Petitioner incurred and paid legal fees and expenses of \$481,330.30 in defending itself against the claims made in the Lawsuit.

6. Petitioner has not been reimbursed in any way for any part of the amount paid in settlement of the claim of the Board or for the legal fees and expenses incurred in connection therewith, and petitioner is not seeking reimbursement thereof for any part of such amounts or the contribution thereto from any other party.

7. Petitioner filed a timely claim for refund of a portion of the gains tax it paid. Petitioner's claim is based on: a) reducing the consideration it received (and thus its taxable gain) by the amount paid to the Board in settlement of the litigation and, b) increasing its

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<sup>1</sup>The real property transfer gains tax imposed by Tax Law Article 31-B was repealed on July 13, 1996. The repeal applies to transfers of real property that occur on or after June 15, 1996 (L 1996, ch 309, §§ 171-180).

original purchase price (and thus reducing its taxable gain) by the amount of legal fees and expenses incurred in defending against the Board's lawsuit. More specifically, petitioner is claiming a gains tax refund in the amount of \$198,133.00, based on a \$1,500,000.00 reduction in consideration for the settlement payment made to the Board and a \$481,330.30 increase in original purchase price for the legal fees and expenses incurred in defending itself in the Lawsuit.

8. Petitioner's refund claim was denied by the Division, and such denial was thereafter sustained, after a conciliation conference, by the Division's Bureau of Conciliation and Mediation Services ("BCMS").

9. In support of its claim, petitioner submitted an affidavit made by one David Wynn and executed by him on November 15, 1994. Mr. Wynn is one of the attorneys who was involved in representing petitioner in the Lawsuit and in the settlement thereof. According to Mr. Wynn's affidavit, and as borne out by a copy of the complaint filed in the Lawsuit, the breach of contract was ascribed by the plaintiff/purchasers to a failure to construct the building in accordance with plans and specifications described in the offering plans, written purchase agreements and, in some respects, with the building code of the City of New York. Mr. Wynn states that it was apparent to petitioner, upon review of the complaint, that the plaintiff/purchasers' allegations of breach of contract were meritorious, and that petitioner faced exposure to liability for damages attributable thereto. Finally, Mr. Wynn notes that as part of the settlement, the Board of Managers agreed to apply petitioner's \$1,500,000.00 payment amount, net of expenses, to the correction of the defects in the building and in the purchasers' individual units.

#### ***SUMMARY OF THE PARTIES' POSITIONS***

Petitioner maintains that the settlement payment represents a reduction in the selling prices of the units, in effect a payback or rebate to the unit purchasers to compensate them for the cost of correcting the defects in the building. Petitioner argues that the selling price, and thus the measure of consideration, should equal the contract price for the building, less

allowance for the settlement payment made to complete omissions and correct defects existing at the time of the unit transfers and forming the basis for the unit owners' lawsuit for breach of contract. Petitioner maintains that the defects existed at the times of the unit sales, and thus the unit purchasers' causes of action against petitioner for breach of contract accrued and arose at the times of the individual condominium unit sales to such purchasers. Petitioner notes that under CPLR 203, the unit purchasers' statute of limitations period for the breach of contract action is measured from the dates of such unit transfers. Petitioner argues that the price reduction via settlement is not a "subsequent event", but rather is the valuation of the damages for the breach of contract, which breach existed and became actionable on the dates of transfer of the individual condominium units. In this regard, petitioner maintains that although the dollar amount of the damages was determined at a point after the breach, such amount represents the value of the damages at the time of the breach. Petitioner argues, in turn, that determining the amount of the damages at a point in time later than the transfer date does not make the breach a subsequent event. Petitioner argues that the settlement payment is the valuation of a condition (the defects) which existed at the times of the unit transfers, and that, as in Matter of Forty Second Street Company v. Tax Appeals Tribunal (219 AD2d 98, 641 NYS2d 151), such valuation (i.e., the measure of damages for breach) was not dependent on any event which may or was to occur after the transfers. In sum, petitioner claims that with no dispute that the property was transferred in a defective condition thus giving rise to a cause of action for breach on the dates of transfers, it follows that the only issue was a valuation of the defects. Since such valuation was based on the facts and state of the defects as of the dates of transfers, and was not dependent on some post-transfer event or condition, petitioner is entitled to a reduction of the selling price (consideration) based on its payback or "rebate" in light of the damages as so valued.

11. Turning to the claim for reduction of gain (and tax) based on allowance of legal fees incurred in defending the lawsuit, petitioner maintains that the same represented ordinary, necessary and reasonable expenses of sale per Tax Law § 1440(5)(a) and 20 NYCRR 590.17.

In this regard, petitioner claims that the fees were incurred directly in defense of a lawsuit arising in connection with petitioner's profit-making activities, and thus such fees are allowable as directly tied thereto. Petitioner goes on to point out that the initial claim was for forty million dollars, and that while such figure was (as is common) overstated by the plaintiffs, the underlying claims were nonetheless meritorious. Petitioner notes that the claims were settled for the not insignificant sum of \$1,500,000.00, with such amount to be applied to cure the defects underlying the lawsuit. Finally, petitioner argues that the lawsuit involved multiple attorneys from multiple firms and spanned a period of over five years (1988 through 1993) from commencement to resolution, thus bearing out the claim that the amount of fees incurred was reasonable.

12. The Division argues, in contrast, that the consideration was set and known at the times of the transfers and, citing to South Suffolk Recreation Ventures, Inc. v. Tax Appeals Tribunal (\_\_\_ AD2d \_\_\_, 638 NYS2d 515, lv denied, 88 NY2d 803, 645 NYS 2d 446), maintains that the subsequent settlement agreement resulting in payments to the unit purchasers cannot serve as the basis to reduce the amount of such consideration. The Division argues that resolution of the breach of contract litigation by settlement is an event taking place subsequent to the transfers of real property and thus does not allow reduction of the amount of consideration paid on the dates of transfer (citing Matter of Wanat v. Tax Appeals Tribunal, \_\_\_ AD2d \_\_\_, 638 NYS2d 251, lv denied, 88 NY2d 803, 645 NYS2d 446; Matter of Cheltoncort Co. v. Tax Appeals Tribunal, 185 AD2d 49, 592 NYS2d 121; Matter of Brockman, Tax Appeals Tribunal, April 4, 1996; Matter of Starburst Development Co., Tax Appeals Tribunal, May 5, 1994).

13. On the issue of legal fees, the Division argues that they were not incurred to transfer real property or to remove an encumbrance in order to allow a transfer to occur, but rather were incurred to effectuate the settlement of a lawsuit. The Division thus maintains such fees are not allowable as a selling expense, but rather likens the same to fees incurred in the defense and

protection of title to real property, citing to Matter of Preferred Rentals, Stockton Building, Inc. (Tax Appeals Tribunal, March 21, 1996).

### ***CONCLUSIONS OF LAW***

A. During the period at issue herein a tax, commonly known as the gains tax, was imposed at the rate of ten percent on the gain from the transfer of real property in New York State. There is no dispute that petitioner's condominium project was subject to this tax. However, there is a dispute as to the amount of such tax. Specifically, the dispute in this case centers on whether petitioner may reduce the gain subject to the tax by its payment in settlement of the breach of contract litigation and by the amount it expended in legal fees on such litigation. The dollar amounts of the settlement payment (\$1,500,000.00) and legal fees (\$481,330.30) are not in question.

B. Neither party challenges the well established principle, repeatedly set forth in the above-cited cases, that "the value of consideration is fixed for purposes of calculating the gains tax at the time of transfer; subsequent events, even if they diminish the value of the property or change the value of the assets transferred, do not affect the gains tax owed [citations omitted]." (Matter of Wanat v. Tax Appeals Tribunal, *supra*.) However, the parties differ over whether this case involves a "subsequent event", the occurrence of which cannot serve as a basis for revaluing (reducing) consideration on the date of transfer, as opposed to the "subsequent actual valuation" of the consideration as of the dates of transfer. Stated differently, the distinction to be made is whether this case involves a post-transfer renegotiation of consideration versus a determination of the value of consideration for property that was defective, per contract standards, at the time of transfer.

C. Petitioner in this case was embroiled, as the defendant, in extensive breach-of-contract litigation over the condition of the property as transferred. This litigation was commenced in July 1988, which date falls within the February 1985 through January 1990 period during which condominium transfers were ongoing (see Findings of Fact "2" and "3"), and continued until its resolution by settlement some five years later in July 1993 (see Finding of Fact "4"). It is true

that the valuation of the defects in the building, memorialized in the form of the 1993 settlement of the purchasers' breach-of-contract action, itself occurred subsequent to the dates of transfer of the units and thus literally was a subsequent event. However, such "event" was simply the subsequent valuation of an item (the cause of action for breach) existing in favor of the purchasers and becoming actionable on the dates of transfer. Therefore, the basis upon which reduction of consideration is predicated was a matter arising and existing contemporaneously with the transfers, with the subsequent settlement of the lawsuit for breach representing merely the valuation of the defects underlying the claim for breach. Accordingly, the fact that the value of the defects was not determined until well after the dates of transfer does not render the same a subsequent event or preclude the adjustment sought by petitioner. As stated in Matter of Wanat (supra), "the Legislature intended the transfer of property of a certain value and gain to be a taxable event, with the tax to be measured by calculations of value upon the occurrence of that taxable transfer, . . . ." (emphasis added). Here, petitioner's position allows for the tax to be measured by the calculation of the value of the property, in light of the acknowledged defects therein, upon the occurrence of transfer. In short, the alleged "subsequent event" was in fact only the culmination of the process of arriving at the value of the defects constituting the breach (i.e., the ultimate determination of the diminution in the value of the property due to the breach as of the dates of transfer).

This case does not involve a post-transfer failure of consideration as in Matter of Wanat (supra) (foreclosure based on mortgagor's default in payments), or a voluntary (though unexplained) agreement by a transferor to a reduction in the selling price of property previously transferred as in Matter of South Suffolk Recreation Ventures, Inc. (supra). Rather, this matter more closely parallels the result, premised on application of the same "subsequent event" standard, reached in Matter of Cheltoncort (supra) and Matter of Forty Second Street Co. (supra). In these cases, the value of consideration was determined as of the date of transfer, notwithstanding that such valuation was made at a point in time subsequent to the dates of transfer. In Matter of Forty Second Street Co., which involved a transfer of property resulting

from a taking by condemnation, the court order in the condemnation proceeding expressly provided for a post-taking determination of the fair market value of the property as of the date of the taking by condemnation. In turn, the determination of such value, though of necessity occurring subsequent to the date of transfer, was not a subsequent event for gains tax purposes. Accordingly, tax and interest accrued from the date of transfer notwithstanding that the amount to be paid for the property had not, as of the date of transfer, been determined or paid.

Similarly, in the case at hand, the post-transfer valuation of the defects in the property as they existed on the dates of transfer, via settlement of the lawsuit, is not a subsequent event but is the culmination of the process of determining the value of the consideration as of the dates of transfer. The "event" or reason for the need to recompute the value of the consideration stems from the fact that the property was, concededly, in a defective condition per contract standards at the time of transfer. Thus, the amount of consideration at the time of transfer, as ultimately valued, was not determined by or dependent upon any indeterminate future event which might occur after transfer, but rather was determined based on a resolution of the dollar value of the defects in the property at the time of transfer.

In Matter of Harkness Company (Tax Appeals Tribunal, May 16, 1991), the Division sought to treat a one million dollar payment made to a transferor in settlement of litigation as additional consideration received for property (thereby both increasing the consideration for the property and, because such payment was made after the effective date of the gains tax, disqualifying the transfer from the so-called grandfather exemption from the tax). The Tribunal held that the settlement payment was not additional consideration for the property transferred, but was paid to settle a lawsuit and compensate Harkness for legal fees and for the monetary loss suffered as the result of delay in closing on the property caused by the litigation. It was noted that the payment in Harkness was required to be made whether or not the pending property transfer took place. As in Harkness, the payment by petitioner in this case was made in settlement of litigation. However, in contrast to Harkness, the payment was not made to compensate for losses caused by time delays, but was to compensate unit purchasers for the



defects existing in their properties at the times of transfer. Also unlike Harkness, where the payment was required to be made whether or not the transfer occurred, there would be no reason for the payment in this case unless and until the transfers had occurred. According to the affidavit of David Wynn, the condominium Board of Managers specifically agreed that such payment was to be used to correct the defects in the building and in the individual condominium units. Accordingly, petitioner is entitled to reduce the amount of consideration received by the amount of the settlement payment.

D. Petitioner also argues that legal fees and expenses incurred in defending against and resolving the breach of contract action constitute ordinary, necessary and reasonable fees incurred to sell the property which are allowable as part of original purchase price for the property per Tax Law § 1440(5)(a). This argument is rejected. On this issue, the Division does not argue that the fees and expenses were unreasonable as excessive. Indeed, given the numerous claims and parties, multiple law firms and substantial amounts of money at issue, it cannot be said that the dollar amount of fees and expenses incurred, though substantial, were clearly unreasonable. However, the Division maintains that the transfers in question (sales of the condominium units) occurred without regard to the lawsuit, and that there is no evidence or claim that such transfers were contingent upon a satisfactory resolution of the lawsuit. Accordingly, the Division argues that the legal fees and expenses in question were simply not necessary and allowable selling expenses.

In Matter of Preferred Rentals, Stockton Building, Inc. (Tax Appeals Tribunal, March 21, 1996), the Tribunal rejected a claim that a lis pendens is an encumbrance on real property the removal of which, via a settlement payment, constitutes a cost of acquiring property which is includable in original purchase price. On the same basis the Tribunal also held that legal fees incurred in connection with removing a lis pendens are not acquisition costs includable in original purchase price. However, the Tribunal went on to hold that since removal of the lis pendens was a condition precedent which had to be fulfilled in order to allow the property transfer to occur, legal fees incurred in removing the lis pendens did constitute a necessary and

allowable selling expense under Tax Law § 1440(5)(a). In contrast to Preferred Rentals, the legal fees at issue in the present matter were not incurred as an expense necessary to allow the condominium sales to occur, but rather were incurred to defend and effectuate the settlement of a lawsuit. As the Division points out, the sales of the condominium units in this case were made irrespective of the lawsuit, and the legal fees and expenses at issue were therefore not costs necessary to effectuate such sales. Accordingly, such fees and expenses were not allowable selling expenses per Tax Law § 1440(5)(a) (see, Benaquista, Polsinelli and Serefini Management Corp. v. Commissioner of Taxation and Finance, 191 AD2d 80, 598 NYS2d 829).

E. The petition of 93rd Street Associates is hereby granted to the extent indicated in Conclusion of Law "C" but is otherwise denied.

DATED: Troy, New York  
December 19, 1996

/s/ Dennis M. Galliher  
ADMINISTRATIVE LAW JUDGE